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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1011

DATRONICS ENGINEERS, INC., *Petitioner*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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The Petitioner, Datronics Engineers, Inc., respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered in this proceeding on July 27, 1973, as amended on September 28, 1973, upon a timely filed Petition for Reconsideration.

OPINIONS BELOW

The oral opinion of the United States District Court for the District of Maryland, filed July 17, 1973, and the opinions of the United States Court of Appeals for the Fourth Circuit filed on July 27, 1973, and

September 28, 1973, are reproduced in the appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Fourth Circuit was entered on July 27, 1973. A timely Petition for Reconsideration was filed by Datronics on August 9, 1973, which was granted in part on September 28, 1973.

QUESTIONS PRESENTED

The Securities Acts of 1933 and 1934 regulate the sale, purchase and offer of sale or purchase of securities. Congress deliberately excluded stock dividends from coverage. Until July 2, 1969, the SEC publicly took the position and consistently held that dividends in the form of "spin-off" stock of subsidiaries were not subject to the coverage of these Acts. Acting in reliance on the statutes and Commission construction, Petitioner formed subsidiary corporations and spun-off the stock to its own stockholders as stock dividends. After distribution of these stock dividends, the Commission brought suit to enjoin this procedure. The Fourth Circuit, reversing the District Court, held that the Acts were violative of the Securities Acts. In this situation, the questions presented are:

1. Whether the Court below was correct in construing the Securities Acts of 1933 and 1934 so as to apply to dividends in the form of stock of subsidiary corporations.

2. Whether the Commission and the Court below, having found an evil in stock dividends, violated the doctrine of separation of powers to stretch the Securi-

ties Acts so as to apply to this situation, which Congress deliberately and expressly left unregulated.

3. Whether, assuming any ambiguity in the statutes, the Court below correctly sanctioned the Commission's action in construing as subject to regulation an area it had theretofore publicly ruled to be not subject to regulation and by applying such a changed position *ex post facto* so as to catch in its web and realistically to punish those who had relied upon its earlier position, all in direct contravention of this Court's holding in *Moser* v. *United States*, 341 U.S. 41, 46 (1951), and the clear purpose of the publication provisions of the Administrative Procedure Act, 5 U.S.C. 522(a)(1).

STATUTES AND REGULATIONS

The pertinent portion of the Securities Act of 1933, 15 U.S.C. 77a, the Securities Exchange Act of 1934, 15 U.S.C. 78a, and SEC Rule 10b-5 under the Exchange Act of 1934 are contained in the Statutes and Regulations Appendix attached hereto. In addition, SEC Release No. 33-929, July 29, 1936, 11 F.R. 10957, and SEC Securities Act Release No. 33-6982, 34 F.R. 11581, are contained in this Appendix.

STATEMENT OF THE CASE

For an understanding of the issues in this case, it is well to look first to the statutory and regulatory scheme, then at the particular facts, and finally to the proceedings in the courts below.

A. The Statutory and Regulatory Scheme.

As this Court well knows, Congress has legislated a pervasive regulation of the securities market. The principal statutes regulating the distribution of securi-

ties are the Securities Act of 1933, 15 U.S.C. 77a, and the Securities Exchange Act of 1934, 15 U.S.C. 78a. While this scheme is pervasive as far as it goes, no one claims it all inclusively governs every transfer of a security from one person to another. Rather, the regulation is limited to sales, purchases, offers for sales or purchases, and statements in connection with sales or purchases of securities. This is clearly demonstrated by an examination of the statutory provisions pertinent to this case.

Section 5 of the 1933 Act, when applicable, requires the registration of securities. For Section 5 to apply, however, there is a requirement most pertinent to this case. Section 5 is limited to instances in which facilities of interstate commerce are used "to sell such security" or "for the purpose of sale or delivery after sale," whether "directly or indirectly." Section 17(a) of the Act, making it unlawful to make untrue statements or to omit true ones that are material, likewise applies only to "the offer or sale of any securities. . . ." Finally, Section 10(b) of the Securities Exchange Act of 1934 applies only "in connection with the purchase or sale of any security. . . ." The Securities and Exchange Commission Rule 10b-5, applying that Section, uses identical language.

Section 2 of the 1933 Act, 15 U.S.C. 77b defines the terms "sale" or "sell" to "include every contract of sale or disposition of a security, or interest in a security, *for value*." And it defines an "offer" to "include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, *for value*." (Emphasis added.) Section 3(14) of the 1934 Act, 15 U.S.C. 78c, defines sale merely to include "contract to sell or otherwise dispose of."

Thus, it is clear and beyond cavil that the statutory scheme is one that is applicable in some way to a sale, a purchase, or an offer of a sale or purchase. It does not apply to other transfers, such as a mere gift, and the transfer must be for value.

More specifically, the question arose during the writing of these statutes as to whether the legislative scheme would apply to stock distributed by a corporation to its own stockholders. The House of Representatives Bill specifically exempted such distributions of stock. H.R. Rep. 85, 73rd Cong., 1st Sess. (1933). This provision was stricken during the Conference as being unnecessary, for in the opinion of the Conference Committee such stock distributions "do not constitute a sale, not being given for value." H.R. Conf. Rep. No. 152, 73rd Cong., 1st Sess. (1933).

The Commission, at a very early date, stated officially that this was its position. In Securities Act Release No. 33-929 (1936), the Commission, speaking through its General Counsel, made clear that the distribution of stock as a dividend to stockholders did not constitute a sale within the meaning of the Securities Acts and that, more specifically, no registration of such securities would be required. The Release clearly states that, where a corporation declares a dividend in securities, "neither the declaration of the dividend nor the distribution of securities to stockholders . . .would in my opinion constitute a sale within the meaning of the Securities Act. . . ." This Release was printed in the Federal Register as official notification to all concerned. 11 Fed. Reg. 10957 (1936).[1]

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[1] Release No. 33-929 concerned a dividend option of cash or securities. As there clearly is no basis for claiming that a purely cash dividend comes within either Act, it is the stock dividend here that is significant.

This position of the Commission was reiterated as recently as 1962 when the Commission made clear in a "Training Manual on Securities Act of 1933" that "spin-offs and stock dividends" are not subject to registration. Thus, the Manual explains, where "a parent corporation declares a dividend to its stockholders payable in the stock of a subsidiary corporation [, s]uch a dividend would not constitute a sale within the principles set out in the 1933 Act Release No. 929. Hence, the stock of the subsidiary corporation would not be required to be registered." *Id.* at 9.[2]

The Security and Exchange Commission publicly indicated a change of position for the first time on July 2, 1969, in its Securities Act Release No. 33-4982, 34 Fed. Reg. 11581 (July 15, 1969). And even then, it added a qualification:

> This release does not attempt to deal with any problems attributable to more conventional spin-offs, which do not involve a process of purchase of securities by a publicly-owned company followed by their spin-off and redistribution in the trading markets.

No definition of the term "conventional spin-offs" was offered. No further explanation was offered prior to the filing of the instant suit.

B. The Factual Context

Petitioner, during the period prior to the indication of a change of position on the part of the Commission, entered into agreements with eleven individuals and

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[2] The Commission authorized the use of this Manual at various public institutional programs for stockholders, attorneys and other members of the public interested in the securities industry. *Id.* at ii.

corporations.[3] In the case of several that were not incorporated, corporations were formed. In each of the nine instances on which this suit is based, the agreement called for the corporation, whether formed or preexisting, to become a subsidiary of Datronics and for Datronics to distribute stock of the subsidiary to the Datronics stockholders as stock dividends. In each case the agreement was entered into prior to the July, 1969, SEC Release referred to above. In each case the subsidiary corporation was incorporated prior to the July, 1969, SEC Release. In each case, the stock dividend was announced to stockholders prior to the July, 1969, Release. In each case but two the stock dividend was actually distributed to the Datronics stockholders prior to the July, 1969, Release.[4] Datronics engaged in this activity, which was foreign to its usual corporate activity, for what it considered to be the sound business purpose of expecting to generate income to tide it over a period of expensive litigation then in progress.[5]

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[3] Two additional agreements were entered into. But as the agreements were never consummated and the stock was never spun-off, they were not a part of the basis of this suit.

[4] In one of the two instances not sued upon, Heritage Foods, Inc., the agreement was entered in on September, 1969; the spin-off was announced to Datronics stockholders on October 20, 1969, and distribution was made in February, 1970. In that case, Datronics attempted to register the stock with the S.E.C. and when distribution was made, the stock was restricted so as to be not freely tradeable in the public market at that time. In the other instance, New Issues Digest, Inc., the agreement and incorporation occurred before July, 1969, though distribution occurred in September, 1969.

[5] Datronics expected to benefit by retaining some of the stock of the subsidiaries in return for the services rendered. Two of the Datronics' principals personally received shares in the subsidiaries in return for services rendered. This stock was restricted and the restriction was legended upon the certificates. Thus, both the stock retained by Datronics and that received by the principals,

There is no evidence that Datronics or any other Defendant did anything to arrange or encourage an active trading market in the shares of the subsidiaries that were distributed to Datronics stockholders. No agreement was entered into with any broker-dealer to underwrite or sell or otherwise trade the stock. The fact is that some of Datronics' more than 1,000 stockholders were broker-dealers, holding Datronics stock in street names. As Datronics stockholders they received, along with all the other Datronics stockholders, announcements of the stock dividends and the stock dividends themselves. The fact is further that once the stock dividends reached the hands of the Datronics stockholders (in one instance after the announcement was made but prior to actual distribution) trading commenced over-the-counter. The fact is also that the National Quotations Bureau, which lists stock trading over-the-counter, requested information from Datronics about some (or all) of this stock and received replies to the requests made.

Finally, it is asserted by the Commission, and for the purpose of this Petition must be assumed, that in connection with three of the eleven stock dividends, Datronics gave to its own stockholders certain information which in itself was not true or omitted advising them of material information.

It should be noted that in no instance was a Datronics stockholder asked to give anything, whether of value or not, to Datronics or to a Datronics subsidiary nor to anyone else. Nor at any time was anything of value given. Nor at any time was any offer made to a Datronics stockholder by Datronics or one of its subsidiaries. Rather, all that the Datronics stockholder received was an announcement that he or she would re-

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were not freely tradable in the public market at that time and for a significant period thereafter.

ceive as a dividend shares of stock in a subsidiary corporation.

It should also be noted that once the Datronics stockholders received the stock dividends, and once the over-the-counter trading began, an ascertainable market value for the stock existed.

The Commission's informal investigation of this matter began in early July, 1969. A Formal Order of Investigation was issued on September 29, 1969.

C. The Proceedings Below

The Commission instituted the present action in January, 1971, seeking to enjoin the practice here noted. The Commission claimed that in nine of the eleven instances the stock dividends and the announcements of the stock dividends were "sales" or were "in connection with sales" within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934 requiring registration and prohibiting misstatements or omissions of material facts. The Commission moved for a preliminary injunction. The Defendants[6] moved for summary judgment on the ground that the stock dividends and the announcements of the stock dividends did not constitute sales, offers to sell, or statements in connection with sales and therefore did not come within either of the Federal Acts.

The District Court granted Defendants' Motion for Summary Judgment, holding that the stock dividends and the announcements of the stock dividends were not sales, offers of sales, or statements made in connection

[6] The other Defendants were seven of the subsidiaries and three individuals, including two who were at the time principals in Datronics but have since severed all relations with Datronics.

with sales. The Court therefore held that neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 governed or was intended to govern the communication between Datronics and its own stockholders or the stock dividends given to them. The District Court further held that, as a matter of discretion, it would not preliminarily enjoin Datronics. It so held upon its findings that Datronics had come under new management in July, 1972; that the majority owners had released the previous principals from service to the Corporation;[7] that Datronics would not intend to engage in any further stock dividends of the nature described unless and until they were adjudicated to be valid; that there was no reason to distrust the disclaimers of future violations by the current owners of Datronics; that Datronics had proceeded on the advice of counsel; that all stock in the subsidiaries retained by Datronics or any of its principals were restricted and legended to prevent their public sale; that the Datronics board had not considered the question of markets and public trading; that there was at best serious ambiguity in the law concerning the legality of the stock dividend spin-off procedure, that the Commission's Training Manual of 1962 and its Release of July 2, 1969, were at best confusing and perhaps misleading, and that a showing of reformation had been made to the Court's satisfaction.

The Court of Appeals reversed, holding that these stock dividends and the announcements thereof were sales, offers for sale, and/or statements in connection

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[7] The one exception by which one of the former principals, an attorney, would continue to represent Datronics in complicated litigation then in progress is narrowly limited and not suggested by anyone to be material.

with sales of securities within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934, and that Datronics was an underwriter under those statutes.[8] The Court of Appeals first directed that all Defendants be preliminarily enjoined. Upon Datronics' timely Petition for Reconsideration, the Court of Appeals rescinded its direction that the District Court enter the preliminary injunction at least as against Datronics. The Appellate Court noted the stressed reassurance of the owners of a majority of Datronics stock that no more stock divdend spin-offs would be undertaken, that the majority stockholders will not vote their stock in the future for any such transaction or elect as a director any person who would so vote, that the principals involved in the challenged stock dividend are no longer associated with Datronics, and that a merger of Datronics within another firm is in contemplation. In these circumstances, the Court apprehended that the injunction "might have a punitive effect, which was not intended" and therefore rescinded its direction for its entry and remanded to the District Court for a determination as to whether an injunction should be issued.

The District Court has not yet acted upon the remand.

REASONS FOR GRANTING THE WRIT

The judgment of the Court of Appeals presents issues of great moment to the roles of the respective branches of Government in our Constitutional system and to the citizen who must act in reliance upon the

[8] Judge Widner concurred "with so much of the opinion as holds that Datronics may be an underwriter within the meaning of the statute."

official and public pronouncements of duly constituted agencies of Government. These issues are squarely presented in this case and are now ripe for review by this Court. And, if not reviewed now, may never come before this Court again in this case, to the potential serious detriment of thousands of persons who relied upon the plain language of a statute and of the official announcements of the agency charged with its implementation.

1. It may be that there is good reason to regulate the issuance of dividends in the form of stock distributed by a corporation to its own stockholders, which in the final analysis is a distribution by the stockholders to themselves of what they already own. It may be that there is good reason for the Federal Government to regulate announcements and other information given by a corporation to its stockholders in connection with matters other than sales or purchases of stock. But the fact is that Congress has not so legislated. The evils that Congress perceived and legislated against in the 1933 and 1934 Securities Acts were the sales and purchases and offers to sell securities and statements made in connection therewith. Stock dividends were not intended to be regulated, as the Conference Committee Report made clear (see p. 5, supra). And this intent was early accepted by the Commission in an official public pronouncement printed in the Federal Register (see p. 5, supra). Now an evil is perceived in at least some stock dividends. Perhaps that evil should be eliminated. But the first step must be legislation to regulate or authorize regulation of the area purposefully left unregulated by Congress.

The Commission argues, and the Court of Appeals found, that Datronics received value when the dividend

stock was traded and thus there was established a market value for its then held and restricted stock. It also argues and the Court of Appeals found that the subsequent sales by the Datronics stockholders to others were the sales to which somehow or other Datronics was a party and thus brought the whole transaction under the Securities Acts. These arguments we submit are but sophistic stretching of clear statutory language and express Congressional intent to cover a found evil which Congress deliberately intended not to regulate. This we respectfully suggest goes beyond the power of both agency and court.

It is, of course, Hornbook Law that a gift, a stock dividend, or a return of capital is *not* a "sale". It is *not* a "sale" because no value passes from the so-called "buyer" to the so-called "seller." The same basic Hornbook Law applies to the appreciation of assets held by a donor, or corporation, which has either issued a stock dividend or a return of capital. It is not "bargained-for" value, as that term is used as a term of art. The attempt to make this transaction a sale is, we respectfully submit, a procrustean exercise to cure a found evil in an area deliberately left unregulated by Congress.

It is respectfully submitted that the holding of the court below violates the doctrine of separation of powers and is a blatant exercise in judicial legislation. The federal judiciary has no power to amend, in practical effect, an Act of Congress under the guise of interpretation, nor to so depart from sound rules of construction as to make new law not enacted by the legislative branch of a republican government. *Dewey* v. *United States*, 178 U.S. 510 (1899); *United States* v. *Union Pacific R.*, 91 U.S. 72 (1875). The

judicial power of the United States, exercised pursuant to Article Three of the Constitution, does not extend to inverting the ordinary meaning of words so as to remedy what it belives to be a temporary inequity occasioned by the nonaction of Congress. *De Lima* v. *Bidwell*, 182 U.S. 1, 198 (1900).

Datronics does not disagree with the contention that the purpose of the Securities Act is to insure fair and open markets. Datronics does not disagree that that purpose is in the highest public interest.

Datronics *does* disagree with the implict position of the court below that it may amend a statute under the guise of interpretation to reach a found evil in an area intentionally left unregulated by Congress. Such may not be done. *Pillsbury* v. *United Engineering Co.*, 342 U.S. 197 (1951). The responsibility of the judiciary "is to construe and enforce the Constitution and laws of the land as they are and not to legislate policy on the basis of [its] own personal inclinations." *Evans* v. *Abney*, 396 U.S. 435, 446 (1970). The same must be said of an administrative agency.

The Court below states, in essence, that as the disposition of securities was the fulfillment of an obligation of Datronics, it was a sale to Datronics' stockholders. That reasoning, however, is fallacious in that, first, there was no value flowing from Datronics' stockholders to Datronics. Second, at best, it might be claimed that Datronics' stockholders were donee beneficiaries of the "sale" between Datronics and the particular subsidiary involved. That, however, merely converts the disposition to Datronics' stockholders from being a divident issued to them into a donative gift of which they are the beneficiaries. They cannot be claimed to be creditor beneficiaries because, as ad-

mitted by the Commission below, the stockholders owed no obligation to anyone with regard to the shares they were receiving. Thus, that tortured construction of "sale" must be discarded.

It being clear that the Datronics' stockholders had no obligation to do anything with the stock they received, not to mention engage in activity which would lead to appreciation of that stock, there can be no "sale". Further, as the District Court below specifically found that no officer or director of Datronics established, or engaged in activity to establish, a market for the spun-off stock, a finding with which the Court of Appeals did not disagree, it cannot be said that the mere issuance of a stock dividend, or a return of capital, without more, is a "sale." It is certainly not a "sale" within the meaning of the Securities Laws, as passed by Congress. As this Court has explicitly stated, the task of a federal court is "to interpret and apply the law already enacted but not under the guise of construction to provide a more comprehensive scheme or regulation that Congress has decided upon." *Simpson* v. *Shepard (Minnesota Rate Cases)*, 230 U.S. 352, 433 (1912).

2. The second issue squarely presented by this case is whether an official agency of Government may publicly and officially construe a statute permitting more than one construction in one manner and then when citizens are lulled into reliance thereof reverse its field and apply the new construction retroactively so as to engulf in adverse action those who relied. That is this case.

Although we believe and urge in Part 1 of these Reasons that the Securities Acts are susceptible of only

one construction both from their explicit language and from the clear legislative intent—and that construction is to exclude from coverage stock dividends—should the Court disagree, arguendo, the present issue is necessarily presented. For more than thirty years, the Commission has consistently (and we believe correctly) interpreted the Securities Acts to permit dividents to be paid in stock without registration. It so informed the investing public in 1936 by publication in the Federal Register. It so instructed its own agents as well as the public as late as 1962 and on a continuing basis thereafter. Yet in 1969, it reversed its interpretation and soon thereafter commenced litigation against those who had relied upon its prior interpretation.[9] Thus, the Commission caught, in its newly-spun web, persons who had relied upon it for guidance in dealing lawfully in the securities market.

This Court has held before that where a person "had sought information and guidance from the highest authority to which he could turn," that authority, the Department of State, could not later impose upon him a penalty for his good-faith reliance. *Moser* v. *United States*, 341 U.S. 41, 46 (1951). Although the Court has permitted administrative agencies to promulgate new rules in the context of an adjudicatory proceeding where none has been promulgated before, *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 201 (1947), or to apply well-established rules in different manners where the context so requires, *Federal Communications Commission* v. *WOKO, Inc.*, 329 U.S. 223 (1946), this Court has never

[9] The first such action, *SEC* v. *Harwyn Industries*, 326 F. Supp. 943 (S.D.N.Y. 1971), was commenced on June 24, 1970.

sanctioned an agency's promulgation of a new rule, without legislative mandate, and speedy institution of litigation to enforce that regulation, especially where, as here, the allegedly unlawful practices terminated either before the effective date of the new regulation or soon thereafter.

The principal of fundamental justice and due process was behind the provision of the Administrative Procedure Act requiring the publication in the Federal Register of all matters on which the public is expected to rely. 5 U.S.C. 552(a)(1). As this staute expressly states:

> Except to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published.

Clearly, this necessarily implies the Congressional intent that the public may rely on what is there published.

To allow the Commission to engage in the practice attempted in this case would have the most deleterious effect. Not only would this Court's holding in *Moser* be disregarded and the fundamental basis for the publication provision of the Administrative Procedure Act be violated; but more, no person or industry subject to federal regulation could rely from one moment to the next that the course of conduct it had adopted was lawful. The public releases of the particular regulatory body concerned, even when published in the Federal Register, would be devoid of effective guidance, and entrap those relying thereon, if they could not be trusted to be the regulations actually in effect. Indeed, this case is a striking example of an entrepreneur act-

ing in accord with a Commission's official interpretation of the law, only to find that a sudden change of heart on the part of the Commission rendered him liable *ex post facto,* on the basis of a Commission's *post hoc* reinterpretation. Sanction of the Commission's actions in the instant case thus places an imprimatur of judicial approbation upon *ex post facto* liability, and the concomitant instability of Commission statements of policy and procedure.

It is true that this case is not, strictly speaking, a criminal proceeding, and that under the conventional wisdom *ex post facto* legislation is therefore not thought to be banned. But, as the Court of Appeals recognized, a decree in this case constitutes punishment. It is punishment in the sullying of reputations. It is punishment in the destruction of corporate value—as much so as would be done by a criminal fine. It is punishment as far as it opens up Datronics to civil liability under the implied-rights doctrine of *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964), as applied forcefully through collateral estoppel under *Blonder-Tongue Labs, Inc.* v. *University of Illinois Foundation,* 402 U.S. 313, 349-50 (1971), which arguably applies.

In this age when confidence in Government is so shaken, there is no room for the abandonment of the important doctrine of governmental good faith and responsibility recognized in *Moser* and the publication provision of the Administrative Procedure Act.

3. These issues are now ripe for this Court's review. The pertinent facts are not now in dispute and will not be developed further by the proceedings upon remand. Those proceedings realistically go to the en-

tirely separate issues contained in the exercise of discretion by the trial Judge in the issuance of injunctive relief assuming the application and a violation of the Securities Acts. It is this assumption that was decided by the Court of Appeals and which is now before this Court on this Petition.

Even should the trial court refuse to enjoin Datronics, the judgment of the Court of Appeals could have a binding and devastating effect upon Datronics and upon the many hundreds and perhaps thousands of stockholders who have held Datronics stock during the period in which stock dividends were made and were in turn resold by Datronics' stockholders.

Under the implied-private-remedy doctrine of *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964), individual suits could be brought against Datronics on the basis of violation of the Federal Securities Acts by persons who assertedly lost money through the purchase of the subsidiary stock after it had been given to Datronics' stockholders. And if the doctrine of *Blonder-Tongue Labs, Inc.* v. *University of Illinois Foundation,* 402 U.S. 313, 349-50 (1971), is to be applied universally in federal-question cases, the collateral estoppel effect of the decision below could be of tremendous practical effect in such litigation. Indeed, we are not concerned with a mere possibility of private actions. The reality is that eight actions have already been instituted and the basis of these arguments has been pleaded in at least four of these cases.

Even more, under the decision below, Datronics is to be treated as an underwriter. This in turn would make "dealers" out of the several hundreds and perhaps thousands of persons who, as Datronics' stock-

holders, had received the stock dividends and in turn had sold the subsidiary stock to others. As dealers, they too would be subject to suit under the *Borak* doctrine and as successors in interest to Datronics could arguably be subject to whatever collateral estoppel effect is worked by *Blonder-Tongue*. Moreover, the Commission has instituted additional actions against others who had similarly relied upon the statutory language and Commission construction.

E.g. SEC v. Harwyn, supra,

SEC v. Mart Industries, Inc. (Complaint filed SDNY May 28, 1970),

SEC v. South West Amalgamated Properties and Securities, Inc., et al. (Complaint filed U.S.D.C. San Antonio, Tex., June 5, 1970),

SEC v. Les Studs Corporation, et al (Complaint filed SDNY July 9, 1970),

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SEC v. Stern-Haskell, Inc., et al. (Complaint filed SDNY September 30, 1970),

SEC v. Vodel Corporation, et al. (Complaint filed SDNY October 14, 1970),

SEC v. Progressive Investment Corporation, et al. (Complaint filed USDC Phoenix, Arizona November 23, 1970),

SEC v. 1325 Union Corporation, et al. (Complaint filed SDNY December 8, 1970),

SEC v. Richard Treibeck, et al. (Complaint filed SDNY February, 1972).

Thus, the specific issues in this case are of much broader import than their effect solely on Datronics.

The significance of the decision below, however, is even broader than its possible effect upon the thousands of persons involved.

We respectfully submit that the issues squarely presented by this Petition go to the heart of the working of a republican form of government and of a citizen's ability to conduct his affairs in accordance with statute and governmental pronouncements. Resolution of these issues is particularly appropriate at this time in our history.

CONCLUSION

For the reason discussed above, we respectfully submit that a Writ of Certiorari should issue to review the decision of the Court below.

Respectfully submitted,

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APPENDIX OF OPINIONS BELOW

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MARYLAND

SEC v. Datronics

Civil No. 71-25-W

Oral Opinion of Judge R. Dorsey Watkins

July 14, 1972

The Court: Good afternoon.

May I say by way of partial repetition and amplification, the delivery of an oral opinion is not intended to indicate that the case is not one of real significance or importance. It is the result of several things, first, if I were to try to take the time to write an opinion, I couldn't possibly get it out before the end of October; secondly, I think that in fairness, particularly to Mr. Gauthier and Mr. Euzent, and equally in fairness to the public, a decision ought to be made in it.

For Mr. Gauthier, it has been a matter of very serious concern wtih respect to employment. For Mr. Euzent, I don't know whether it was the cause of the breaking up of the firm, or anything of the sort, but it certainly, obviously, has been a matter of importance, and it is to the public. If what is going on is wrong, it should be stopped, and should have been stopped long ago, maybe by a cease and desist order, or maybe by early preliminary injunction, but, anyway, it ought not go on any further.

I have done just about as much as I could on the case, anyway. I have been over the transcripts. I have read everything that has been turned in; some of it twice, and some of it three times. I am pretty nearly as familiar with the case as I am ever going to be, and while the record is, I think, it is fair to say voluminous, there is not, in my opinion, any real dispute at issue of any material fact. It is the legal significance of those facts. There are, of course,

matters in dispute as to just exactly whether representations were made in the various notices, questions, perhaps, as to loans, and matters of that sort, but none of them seems to me to be critical with respect to the disposition of the case.

I will say that I am using the first person quite frequently here. I feel that I have the right to reserve the right to edit if the case is appealed. I don't expect it would be anything material in the way of opinion; a "not" might slip in where it shouldn't, as it happened in some of the pleadings; I might split an infinitive too many times for my satisfaction; there might be dangling participles, or various other things that are not commendable, and I would probably put it in the third person in that event.

As will be readily apparent, part of the introductory matter is being taken from the Supplemental Memorandum of the Plaintiff of November 15, 1971.

The Securities and Exchange Commission instituted this action pursuant to Section 21(e) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78u(e)) and Section 20 (b) of the Securities Act of 1933, as amended, (15 U.S.C. 77t(b)), to enjoin defendants from continuing to offer and sell unregistered securities and from allegedly violating the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Commission's complaint, filed on January 12, 1971, alleges that during a thirteen month period from November 1, 1968 to December 31, 1969, Defendants variously participated in schemes to sell and distribute to public investors the unregistered common stock of nine different companies, Multi-Media Engineering, Inc., Compu-Reader, Inc., Data-Call System, Inc., Hosco, Inc., Bun and Burger International, Inc., Cyclo-Shine Corporation, The Laand Corporation, Daypac Industries, Inc., and Associated Data Management Corporation, in a manner designed to avoid and in violation of the Securities Registration Requirements

of Section 5 of the Securities Act of 1933, (15 U.S.C. 77e). The Commission also alleges that in the course of such sales and distributions the Defendants also variously made untrue and misleading statements, primarily about the history, affairs and financial conditions of these nine companies, their predecessors and the reasons for the distributions and that accordingly the Defendants have engaged in acts and practices constituting violations of the anti-fraud provisions of the Securities Act and the Securities Exchange Act of 1934.

Final judgments of permanent injunction have been entered against Defendants Bun and Burger, Cyclo-Shine and Laand as a result of their consent.

On February 26, 1971, this Court deferred its ruling on the Plaintiff's motion for preliminary injunction and denied without prejudice Defendants' motions to dismiss. The Court expressed its doubt as to the ultimate success of the Plaintiff, but allowed the Plaintiff additional time to supplement the complaint. The Court requested that the Plaintiff provide further facts as to several matters, without, however, restricting Plaintiff from presenting any other theories of recovery, or facts in support thereof.

The Court has jurisdiction under Section 22(a) of the Securities Act, (15 U.S.C. 77v(a)), and Section 27 of the Exchange Act, (15 U.S.C. 78aa). All the Defendants reside, were doing business, or have engaged in transactions which constitute the violations charged in the Commission's complaint, in the District of Maryland.

The shares of the nine companies involved in the so-called spin-offs are not the subject of any registration statement filed with the Commission and no filings for these companies' shares have been made with the Commission pursuant to Regulation A (17 CFR 230.252).

From November of 1968 through December, 1969, Defendants arranged spin-offs or so-called "stock dividends" in

the stock of the nine companies. The spin-offs were publicly announced by Datronics and distributed to approximately 1000 Datronics shareholders residing in various states. In connection with these spin-off distributions, virtually no current or detailed information about the affairs of the nine companies was disseminated and in certain instances misleading statements were made by the Defendants.

The individual Defendants, John T. Gauthier, who was the President, Chairman of the Board and a controlling stockholder of Datronics from early 1961 to at least February, 1970, was a principal architect of and participant in the spin-off arrangements. He was an officer and/or director of six of the Defendant companies.

Sylman I. Euzent, since at least June, 1967, has been Datronics' Secretary and a Director. He was a principal designer of and participant in the spin-off arrangements, and has performed legal and other services for Datronics in connection with these spin-offs. Among other things, Euzent and Gauthier were the negotiators for Datronics with the private companies, made arrangements with transfer agents and prepared so called "Information Statements" subsequent to most spin-offs. In addition, Euzent and Gauthier participated in securing investors for several "private placements" of stock of the spin-off companies. Euzent's law firm received over 166,000 shares of the spin-off companies' stock as compensation for his services or as result of the law firm's ownership of Datronics stock. Euzent personally received over 40,000 shares of spin-off stock.

Irving Newirth was an important participant in at least five or the spin-off arrangements. In addition to being the "finder" of Datronics for at least Hosco, Bun and Burger, Daypac, Adam and Laand, for which he received shares of Datronics, Multi-Media, Bun and Burger, Data-Call, Hosco,

Adam and Laand; a total of 176,500 shares costing him $38,150.

In general, three of the nine companies involved in the spin-offs were wholly owned subsidiaries of Datronics, and six were organized by Datronics to acquire by merger, or by purchase through the issuance of its own stock, the stock and assets of other private companies. In each case, there was an agreement by which Datronics would receive stocks of these nine companies, with the express provision that Datronics would "spin-off" or distribute certain of these shares to Datronics stockholders on a pro rata basis. In a number of instances, the agreements also provided for private sales.

Compu-Reader stock was purchased at ten cents a share. The stocks of the other companies acquired by Datronics was in consideration of one cent a share, paid for by "Management Services", consisting variously of cost of incorporation, preparation of agreements, and details of spinning-off shares.

Rather abbreviated announcements were made to Datronics stockholders in connection with each "spin-off". In some instances, misleading statements were made.

In each instance, dealing promptly began in the spin-off shares. Although information was filed with National Daily Quotations Bureau, publisher of the pink sheet over the counter lists by Gauthier and/or Euzent, in each instance it was not volunteered, but supplied in response to requests; and except in one case (Multi-Media), where it was received by the publisher on the same day as the first listing in the pink sheets, the information was given after listings had appeared in the pink sheets.

Plaintiff contends that Newirth "opportuned"—I imagine it means importuned—his brother-in-law who was a trader in Russell and Saxe to have that dealer enter quota-

tions for the spun-off stocks, and for that reason such quotations, the Plaintiff contends, were made. This has been denied under oath by the brother-in-law. Newirth's health is such that he could not be deposed. While there may be ground for suspicion, the Court is unable to find that Newirth did establish a market for the spun-off stocks. There is no evidence that any such activity, if such there were, is chargeable or attributable to either Gauthier or Euzent. Gauthier and Euzent, in affidavits, have flatly denied directly or indirectly contacting any broker, or creating or participating in creating a trading market.

The law principally applicable is Section 5 of the Securities Act, 15 U.S.C. 77e, which, in appropriate part, reads as follows:

"77e. Prohibitions relating to interstate commerce and the mails.

"(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

"(1) to make use of any means or instrumentalies of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

"(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or delivery after sale."

Then skipping (b), and coming to (c):

"It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, un-

less a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under Section 77h of this title."

Then the term "sale" is defined in U.S.C., 15 Section 77b, which is (3):

"The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value."

Note it does not say simply for "benefit," but for "value." Two more times in (3) the words "for value" are repeated.

While the spin-offs were dividends payable in stock, and were, in some instances, characterized by the Defendants as "stock dividends," they were not "stock dividends" in the ordinary sense in which that term is used—a distribution by a company of shares of its own stock to its own stockholders pro rata. If the spin-offs were in fact true stock dividends, they clearly would be outside the definition of "sale." While the Securities Act does not in terms so provide, the Congressional Conference Committee reported that it had omitted a House provision exempting stock dividends since they "are exempt without express provision as they do not constitute a sale, not being given for value." (House of Representatives Report No. 152, 73d Congress. First Session 25 (1933)).

It is the Defendants' contention that the delivery of the spun-off stocks to the stockholders of Datronics is not a "disposition . . . for value." This was the Court's immediate and present reaction. Certainly, after each or any of the spin-offs, Datronics could not have set up a balance sheet asset with respect to such transaction, as a receivable or otherwise. No stockholder receiving stock was

obligated to do anything to or for Datronics. In ordinary understanding, upon passage of title to the spun-off shares, if this were a sale, the receiving stockholder would be obligated to give to Datronics, and Datronics would be entitled to demand and receive, whatever "value" was involved in the "sale." No effort has been made to materialize any such value, and Plaintiff does not claim that anything as simple and clear cut as this occurred. Instead, Plaintiff argues that there are three "arguments" the acceptance of any of which would lead to a finding of value.

These are:

A "tandem underwriter" approach, which is that the recipient-stockholder and Datronics are underwriters whose transactions are not exempt from the Section 5 requirements. Here, the argument goes, Datronics is an underwriter for the reasons already discussed, that is, it had received for the purpose of distribution. The recipient-stockholder is similarly viewed on the ground that he is selling "for the issuer". I must say that strikes me as being very strange. If he sells, he sells for himself; he is not selling for any issuer. It may be the issuer's desire, but he is not an agent of the issuer, he certainly is not responsible to the issuer, for what price at which he sells, or whether he sells or does not sell, and to say he sells for the issuer, I say, seems to me to be difficult to understand. Although perhaps an innocent participant, the recipient-stockholders' subsequent sales are sufficient participation in the distribution to achieve underwriter status. Without the contemplated "sales" by these persons, the private companies and Datronics would not be able to achieve the public market goal.

"Under this approach, the entire distribution process is analyzed, and the expected sales into the market by the recipient-stockholders, as caused by Datronics and private companies, are violative of Section 5."

One quick answer is that the Plaintiff, in another case in which the same point was raised, took exactly the opposite position.

In Securities and Exchange Commission versus Harwyn, 326 F.Supp. 943 (Southern District of New York 1971), the facts were strikingly similar in this aspect. There there was a spin-off of the stock of one wholly owned subsidiary (here three), and the stock of three privately held companies (here six). One possibly critical distinction, though not on this point, I believe, was that in Harwyn, on November 7, 1968, well before the particular spin-off was authorized, a letter was sent from the office of the Secretary of the company, who was also a Director and General Counsel of Harwyn, "to the National Quotations Bureau to arrange for trading in the shares" later authorized and distributed. On November 21, 1968, the Board of Directors authorized the spin-off, payable December 30, 1968. On January 6, 1969, the stock was quoted in the pink sheets.

Although holding that "value" had been received, the Court with respect to this argument said:

"The parties . . . also agree that the public shareholders of Harwyn who received stock in Harwyn subsidiaries were not issuers, underwriters, or dealers as those terms are used in Section 4(1)."

The Court is not receptive to the argument that Judge Mansfield didn't know what he was saying, or that SEC did not know what it was saying, or that SEC didn't really agree, or that SEC didn't care because it was going to be decided on another ground, or it should be construed as meaning "even if." The language, to me, is perfectly clear, and I think it means what it says and I think correctly it means what it says.

The second argument is the so called "realistic benefits approach," in which the contention is an examination of the entire distribution process shows that each of the nine

private companies received "value" in the form of certain significant benefits, including (1) the avoidance of an expensive, time-consuming registration statement; and (2) the public holding of its stock. The benefits to Datronics, which has retained certain private company shares, also arise from the public holding of the stock. Thus, under this view, Datronics does in essence "sell" and by doing so, in as much as it is an underwriter, its sale transactions have no exemption from registration under Section 4(1) of the Securities Act.

In the three instances where Datronics did not "purchase" from an issuer, but rather spun-off shares which it held of its subsidiary, the Commission's position is that "value" is received as above, and Datronics would nevertheless be an underwriter within the alternate language in Section 2(11), as a person who "sells for an issuer in connection with . . . the distribution of a security."

In Harwyn, the rationale was that the spin-off was effected for the subsidiary by the public company, in order to create a publicly held company and the ensuing trading market, and thus the offers and sales made therein are not only the anticipated result, but are accomplished to benefit the parent and subsidiary. Accordingly, by spinning-off the shares, the public company receives value. Thus, within the meaning of Section 2(11), the public company, Datronics, "sold" in connection with a distribution.

In the Harwyn case, the Court referred to the Defendant's interpretation of Section 2(3) and 5, that since each of Harwyn's spin-offs to its shareholders of unregistered shares of its subsidiary was not for value received from such shareholders, and represented distribution of what they already owned, the Defendants contend that amounted to nothing more than a stock dividend, or change in form of ownership, which, admittedly, has always been considered exempt from Section 5 registration requirements.

The Court said this:

"We must concede that Defendants' interpretation of Sections 2(3) and 5 is neither frivolous nor wholly unreasonable and it appears to have been asserted and relied upon by them in good faith. Apparently it represented a view that evolved through the years as a result of the Commission's issuance in 1936 of Release No. 33-929 and its failure thereafter to dispell the interpretation generally put upon the Release by the bar. Feeding upon itself the view became accepted as a 'loophole' that could be closed only by Congress. It was not until the recent sudden increase in the use of the spin-off technique as a means of converting private into public companies that the Commission became alarmed and sought to stop the abuse of what had theretofore been considered a relatively harmless crack in the integrated structure of the Securities laws."

The Court then went on to say that:

"We see no reason to construe Sections 2(3) and 5 as requiring that the 'value' requiring registration must flow from the immediate parties who received the stock, in this case the Harwyn's shareholders. Here the so-called 'dividends' were not isolated transactions; they were intimately bound up with and in the last three instances mandated by the agreements which required the outside Defendants to infuse new value into the subsidiaries and which contemplated that upon distribution of the 'dividend' shares to existing Harwyn stockholders public trading would occur as a result of some selling their shares to new purchasers."

Then, after omitting the citation:

"When the agreement, spin-off and distribution is viewed as one transaction, there was 'value' received by Harwyn and the inside Defendants in the form of a contribution of substantially new assets to each subsidiary and the creation of a public market in the shares with its resulting benefits to the Defendants, including insiders.

Thus there was ample 'value' to bar Harwyn from acting as a conduit for transformation of private companies into public ones without registration."

I have read and reread the opinion several times. With the greatest respect, which is always prefaced when saying I disagree, I do not find anywhere that Judge Mansfield directly says that there was a sale to the stockholders. Now, perhaps you may argue that that is implicit from his reference to Section 2(3), but all he talks about is value being received by Harwyn, and not value delivered by the stockholders, nor even that there was a sale to the stockholders. They received stock, and the parent received value. Maybe Judge Mansfield's opinion should be the law. I don't think it is. Certainly, with all the contention raised by spin-offs (see The Going Public Through the Back Door Phenomenon an Assessment—29 Maryland Law Review 320; the Spin-off: A Sometime Sale, 45 New York University Law Review 132); Judge Mansfield's concession that the view held by the Defendants in his case, and by the Defendants and the Court in this case, is not unreasonable, and the Securities and Exchange Commission Training Manual with its general characterization of spin-offs as exempt; and the release of July 2, 1969, that spin-offs of wholly owned subsidiaries were exempt, something should have been done by Congress and/or the Securities and Exchange Commission to make crystal clear even to the most humble of District Judges what the law is.

Nor do I think the benefit (as distinguished from value) is the criterion of a sale.

There may be a third party beneficiary transaction. X may say to Y that if you give Z a tape recorder, I will pay you $75; Y does; Y has not sold anything to Z.

So, assuming benefits to Harwyn, does that make the delivery of spun-off stock to its stockholders a sale to them.

I mentioned somewhat facetiously, but semi-seriously, in the course of the discussions, two examples of value without sales.

Going back beyond any of your times, I rather imagine, on Saturdays there were rival "tea companies" who sold tea and coffee; one firm regularly distributed nick-nacks, doodads, baloons to the children of the purchasing parents; the other did not. My parents were the "did nots". I didn't like it. I wanted them to buy from the other company, but religion reared its ugly head, and there was no change.

Well now, were these items given to the children sales to them? Even though the purpose was to promote sales, at least to retain sales, I don't think so.

I mentioned the other: we all have received, from time to time, these samples in the mail or otherwise, and I mentioned the Ultra-brite toothpaste, that I use it, and then I go in the Marshal's Office and some of the cuties there say, "oh, his mouth has sex appeal," and that is broadcast, and 538 District Judges, all the Courts of Appeal Judges, and five out of the nine Supreme Court Justices (naturally there being four dissenters) all buy Ultra-brite. Have I bought Ultra-brite? Have they sold me Ultra-brite? The benefits have been derived from what they did and what I did.

The third is the argument that a "sale" need not occur at each step of a distribution process. Had Congress intended Section 2(1) to read . . . "with a view to the 'sale' of any security" or "had a direct or indirect participation" in a sale rather than a distribution, it would have so stated. Well, I interject, I am not so sure that Congress always states what it means. Thus, under this view, Datronics need not "sell" to the stock recipient to achieve underwriter status continuing the distribution or to violate Section 5. As the agreement provides in the six instances,

the private companies "sold" their securities on condition that Datronics would further distribute them. Consequently, Datronics had a direct or indirect participation in any such "distribution" and, under the broad view of that term, no "sale" at this step would be required.

"It is sufficient for Datronics to assist and participate in the planned distribution and thus cause or set in motion the subsequent sales into a market. Its delivery of the securities to its stockholder-recipients with a reasonable expectation that they will sell to other public investors constitutes aiding and abetting a distribution which includes investor sales.

"To find in spin-off cases that the distribution process ceases at the point of the initial dividend recipient would be contrary to substantial legal authority and ignores the actual intent and plan of the spin-off devisors. By bringing about the spin-off for the purpose of creating trading activity in the market place, both the issuer and the public company-underwriter cause and become participants in the entire distribution, including the sales by the stock recipients into the trading market subsequent to the spin-off. This view seems to closely follow the North American Research Development Corporation case rationale."

This seems to require that there be subsequent sales by Datronics' stockholders in order that there can have been a sale by Datronics to those stockholders. That seems to me to be a non sequitur, but it also seems to me illogical.

Certainly, there is no contractual obligation on the part of Datronics stockholders to do anything, when they get the shares. They can do with them what they please, anything, or nothing. They can sell. They can buy. They can ignore. They put in a safe deposit box. They can make a church contribution; anything they please with them.

Now, what is the situation of this? We have four stockholders of Datronics, A, B, C, and D, each of whom receive 750 shares, though it doesn't make any difference whether it is one company, the same company, or several. A sells 750; Datronics has sold 750 shares to him.

B sells 300; Datronics has sold 300 shares to him.

C sells one on the market; Datronics has sold one share to him.

D received 750 and doesn't sell any; Datronics hasn't sold any.

Now, that doesn't seem to me, really, to make sense. The emphasis of the Plaintiff is that as distinguished from the true stock dividend, perhaps as distinguished from some of the so-called, whatever it may mean, conventional spin-off, or as distinguished from the stock split, the purpose here was to create a market, that it was almost certain that some of these stockholders would dispose of their shares; that some of them would buy additional shares, and that persons not stockholders would buy and later, perhaps, sell.

Well, that is true in the case of any distribution regardless of what it may be. It would be true in the case of the so-called conventional spin-off. It is true in the case of a stock dividend. It is the only reason for a stock split, that the company feels that the shares are quoted too high for a single share, and that a better market can be made—they put it, "we can get more stockholders," which is a nice way of expressing it, if the shares are selling at a lower price, and so the stock split occurs.

Well now, to repeat, the very purpose of it is either to create a market, or to stimulate a market, and so it seems to me that is true of all of these, and is not a distinguishing factor, and is not a basis for a distinction as to the necessity for registration or the absence of necessity

for registration; that each one, necessarily, inevitably, has the effect of affecting the market in some way, in some degree.

Probably, the thing which affects it most is the stock split, yet I don't think the argument has been advanced that because that is its clearly defined purpose, that it falls within the requirements of the Securities and Exchange Act.

None of the arguments is appealing to me.

It is further contended that fraud has been practiced under 240.10b-5. A short answer to that is that 240.10b-5 provides that:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," and then a space, and the text makes it quite clear that the following language applies to all three: "in connection with the purchase or sale of any security."

In one of the briefs, the concluding clause was quoted as part of (c). I don't think it was to intentionally create an erroneous impression, but it is quite clear that in connection with the purchase or sale of any security applies to each and all of these particular ones.

Now, since I have found that there was not a sale of any security, I could stop right there and say that fraud is immaterial. I do think, however, that, though I do not consider it determinative, that at least slight reference should be made partly to show that I did not overlook them, and partly because they have the pro and con aspect. I think that the original charges with respect to Data-Call, Hosco, and Daypac have been materially reduced in significance with the various explanations which have been given, some documented. I think that I have not received a satisfactory explanation for the use of the term "management services," either in balance sheets or anywhere else, because, as I said earlier, it seems to me that it was set up this way so that it could be an income and distinguished from, at the worst, or best, a capitalization, and it is inconsistent, I think, with the actual relationship between the various companies and Datronics.

Further, I cannot, any way, justify the reference in a number of cases that you are getting these shares because of the impracticality of our actually running these companies. As I said, literally, that is true, it was impractical to run the companies when you had to get rid of the majority of the stock that you hold in these companies. However, I think the stockholder receiving that would think that we had intended to go ahead with these matters, and then just found that for good business reasons we were not able to go ahead and do what we otherwise intended to do.

Without meaning to characterize these as approaches, in the least, the literally correct statement can be as deceptive, and perhaps more so, than a completely fraudulent one. "Yes, we struck oil: at 8000 feet, we go two teaspoons full of oil: we struck oil."

"The horse went around the track, a mile track, in a minute and forty-five: sure he did, he was in a truck."

So that you can have things which are literally true, but which are definitely misleading, and I think the impracticality, I will put it crudely, the impracticality is one of those.

I do not feel that, in what I consider to be the controlling elements in the case, the question of the loan applications by Messrs. Gauthier and Euzent, are significant. Obviously, they hoped that these transactions would result in their pecuniary benefit. They would be stupid to go into them if they didn't. The banks, apparently, did not have the same enthusiasm that the would be borrowers had with respect to this as collateral.

Some point was also sought to be made showing state of mind with respect to (a) the distribution, after July 2, 1969 of spin-offs which had been declared before then. First, as Judge Mansfield says, the July 2, 1969 release—he didn't use these words—is certainly not a model of clarity, nor something which is to be praised as disclosure. They did it, and I don't think that there is any real ground of considering this is evidence of wilful wrong doing from that.

There were, I believe, four declarations after July 2, 1969; in two of which distributions were not made; one was made within one week after July 2—I don't know whether seven days is too long a period to digest the significance, if you can understand it, of the release of 7-2-69; the other carried a restricted registration legend, and so there, certainly, if anything is a showing of reformation.

I have tried to consider all the other arguments which were made, contentions by either side, but I don't believe that it is worth setting them up to knock them down.

My conclusion, as I hope may have been gathered, is that these spin-offs were not sales within the meaning of the

Act, and that, therefore, the Plaintiff is not entitled to an injunction.

However, even if I had reached the opposite conclusion, I would go along with the conclusions reached by Judge Mansfield, that, in my discretion, this is not a case in which an injunction should be issued.

We have the fact that the Commission knew, back in March of 1969, what was going on, and didn't do anything about it. We have the fact—I think it was the Multi-Media information to the National Bureau; a copy was sent to SEC; we have a case in which Datronics has come under a completely new organization, and that the 51 per cent owners have released Mr. Gauthier and have flatly stated that they do not intend to have any spin-offs unless and until it has been adjudicated that those spin-offs are entirely legal, so that I do not believe that there would be any justification in enjoining Datronics.

I am fully familiar with the cases which hold that the fact that a person promises he is not going to do it again is not, of itself, a ground for denying an injunction. Here, however, I have no reason to distrust the statements made by the current owners of Datronics. The effect on Messrs. Gauthier and Euzent would be very detrimental. Mr. Euzent's only association with Datronics, I believe, is finishing up certain legal services in which he had previously been engaged; I think that we have to consider the ambiguity in the law, as Judge Mansfield recognized, although he resolved the ambiguity one way, as I resolve the ambiguity, if there be one, the other way. All of the Defendants have legended stock.

I think that there is some support for one of the grounds advanced by Judge Mansfield, advice of counsel. The Wilkie-Farr opinion was qualified, properly qualified; the Texas opinion was fairly strong. I still do not feel I can accept,

certainly not to the full extent that it is urged, that Mr. Euzent, because of personal interest, is incapable of giving an honest legal opinion.

I have read the excerpts from the Board of Directors meeting, and they relied on him. I think that maybe they should discount it a little bit, maybe they shouldn't treat it as entitled to full reliance as from totally independent counsel, but it does seem to me that it is a relevant factor.

And, incidentally, there, I recall the extracts from, I think it is, Mr. Gauthier's deposition, that the question of markets was not discussed by the Datronics' board, that that was not one of the things with which they concerned themselves.

There are, as I mentioned before, the Manual, even the July 2, 1969 release.

All of these seem to me to dictate that the equities are against the granting of an injunction.

The foregoing is intended to constitute my findings of fact and conclusions of law under FRCP 52(a). The Commission's motion for preliminary injunction is denied. The motions of the Defendants for summary judgment are granted.

(Hearing concluded.)

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 72-2240

SECURITIES AND EXCHANGE COMMISSION, *Appellant*,

v.

DATRONICS ENGINEERS, INC., JOHN T. GAUTHIER, SYLMAN I. EUZENT, IRVING NEWIRTH, MULTI-MEDIA ENGINEERING, INC., COMPU-READER, INC., DATA-CALL SYSTEMS, INC., HOSCO, INC., *Appellees*.

Appeal from the United States District Court for the District of Maryland, at Baltimore. R. Dorsey Watkins, District Judge.

(Argued March 7, 1973 Decided July 27, 1973)

Before Bryan, Senior Circuit Judge, and Field and Widener, Circuit Judges.

Jacob H. Stillman, Assistant General Counsel, Securities and Exchange Commission, (Walter P. North, Acting General Counsel, Frederic T. Spindel, Attorney, and Dennis R. Surprenant, Securities and Exchange Commission on brief) for Appellant; Paul N. Sameth and Isadore B. Katz (Jules Fink on brief) for Appellee, Datronics Engineers, Inc.; Sylman I. Euzent, Pro se, for Appellee; John T. Gauthier, Pro se, for Appellee; (Harry Adelberg on brief) for Appellee, Irving Newrith.

ALBERT V. BRYAN, Senior Circuit Judge:

The Securities and Exchange Commission in enforcement of the Securities Act of 1933, § 20(b), 15 USC 77t(b), and the Securities Exchange Act of 1934, § 21(e), 15 USC 78u(e), sought a preliminary injunction to restrain Datronics Engineers, Inc., its officers and agents, as well as related corporations, from continuing in alleged violation of the registration and antifraud provisions of the Acts. The breaches are said to have been committed in the sale

of unregistered securities, § 5 of the 1933 Act, 15 USC 77e, and by the employment of false representations in their sale, § 10(b) of the 1934 Act, 15 USC 78j, and Rule 10b-5 of the Commission, 17 CFR 240.10b-5.[1]

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[1] Section 5 of the Securities Act of 1933, 15 USC.

"§ 77e. Prohibitions relating to interstate commerce and the mails.

"(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

* * * * *

"(2) to carry or cause to be carried through the mails . . . any such security for the purpose of sale or for delivery after sale".

Section 10 of the Securities Exchange Act, 15 USC 78j:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

"Rule 10b-5—Employment of Manipulative and Deceptive Devices

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Summary judgment went for the defendants, and the Commission appeals. We reverse.

Specifically, the complaint charged transgressions of the statutes by Datronics, assisted by the individual defendants, in declaring, and effectuating through the use of the mails, "spin-offs" to and among its stockholders of the unregistered shares of stock owned by Datronics in other corporations. With exceptions to be noted, and since the decision on appeal rests on a motion for summary judgment, there is no substantial dispute on the facts. Datronics was engaged in the construction of communications towers. Its capital stock was held by 1000 shareholders and was actively traded on the market. All of the spin-offs occurred within a period of 13 months—from November 1, 1968 to December 31, 1969—and the spun-off stock was that of nine corporations, three of which were wholly owned subsidiaries of Datronics and six were independent corporations.[2]

The pattern[3] of the spin-offs in each instance was this:

* * * * *

Without any business purpose of its own, Datronics would enter into an agreement with the principals of a private company. The agreement provided for the organization by Datronics of a new corporation, or the utilization of one company into the new or subsidiary corporation. It stipulated that the principals of the private company would receive the majority interest in the merger-corporation. The remainder of the stock of the corporation would be de-

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[2] The subsidiaries were Multi-Media Engineering, Inc.; Compu-Reader, Inc.; Data-Call Systems, Inc., and the remaining six independent corporations were Hosco, Inc.; Bun & Burger International, Inc.; Daypac Industries, Inc.; Associated Data & Management Corporation; Cyclo-Shine Corporation, and The Laand Corporation.

[3] In one or two instances, there was some variation in these mechanics, but there was no deviation in principle from the plan.

livered to, or retained by, Datronics for a nominal sum per share. Part of it would be applied to the payment of the services of Datronics in the organization and administration of the proposed spin-off, and to Datronics' counsel for legal services in the transaction. Datronics was bound by each of the nine agreements to distribute among its shareholders the rest of the stock.

Before such distribution, however, Datronics reserved for itself approximately one-third of the shares. Admittedly, none of the newly acquired stock was ever registered; its distribution and the dissemination of the false representations were accomplished by use of the mails.

I. Primarily, in our judgment each of these spin-offs violated § 5 of the Securities Act, supra footnote 1, in that Datronics caused to be carried through the mails an unregistered security "for the purpose of sale or for delivery after sale". Datronics was actually an issuer, or at least a co-issuer, and not exempted from § 5 by § 4(1) of the Act, 15 USC 77(d) as "any person other than an issuer".

Datronics and the other appellees contend, and the District Court concluded, that this type of transaction was not a sale. The argument is that it was no more than a dividend parceled out to stockholders from its portfolio of investments. A noteworthy difference here, however, is that each distribution was an obligation. Their contention also loses sight of the definition of "sale" contained in § 2 of the 1933 Act, 15 USC § 77b. As pertinent here that definition is as follows:

> "When used in this subchapter, unless the context otherwise requires—
>
> • • •
>
> "(3) The term 'sale' or 'sell' shall include every contract of sale or *disposition* of a security or interest in a security, *for value*. The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, *for value*. . . ." (Accent added.)

As the term "sale" includes a "disposition of a security", the dissemination of the new stock among Datronics' stockholders was a sale. However, the appellees urged, and the District Court held, that this disposition was not a statutory sale because it was not "for value", as demanded by the definition. Here, again, we find error. Cf. Securities and Exchange Commission v. Harwyn Industries Corp., 326 FS 943, 954 (S.D.N.Y. 1971). Value accrued to Datronics in several ways. First, a market for the stock was created by its transfer to so many new assignees—at least 1000, some of whom were stockbroker-dealers, residing in various States. Sales by them followed at once—the District Judge noting that "[i]n each instance dealing promptly began in the spun-off shares". This result redounded to the benefit not only of Datronics but, as well, to its officers and agents who had received some of the spun-off stock as compensation for legal or other services to the spin-off corporations. Likewise, the stock retained by Datronics was thereby given an added increment of value. The record discloses that in fact the stock, both that disseminated and that kept by Datronics, did appreciate substantially after the distributions.

This spurious creation of a market whether intentional or incidental constituted a breach of the securities statutes. Each of the issuers by this wide spread of its stock became a publicly held corporation. In this process and in subsequent sales the investing public was not afforded the protection intended by the statutes. Further, the market and the public character of the spun-off stock were fired and fanned by the issuance of shareholder letters announcing future spin-offs, and by information statements sent out to the shareholders.

Moreover, we think that Datronics was an underwriter within the meaning of the 1933 Act. Hence its transactions were covered by the prohibitions, and were not within the exemptions, of the Act. §§ 3(a)(1) and 4(1) of

the 1933 Act, 15 USC 77c, 77d. By definition, the term underwriter "means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking. . . ." § 2(11) of the 1933 Act, 15 USC 77b(11). Clearly, in these transactions the merger-corporation was an issuer; Datronics was a purchaser as well as a co-issuer; and the purchase was made with a view to the distribution of the stock, as commanded by Datronics' preacquisition agreements. By this underwriter distribution Datronics violated § 5 of the 1933 Act—sale of unregistered securities.

II. The Commission charged a violation by Datronics and its officers of § 10b of the 1934 Act, 15 USC 78j, and of Rule 10b-5. The breach occurred through untrue factual statements incident to the spin-offs. The District Court quite justifiably found that "in certain instances misleading statements were made by" Datronics and the individual defendants. This finding was reiterated by the District Court in discussing the announcements which were made to Datronics' stockholders with each spin-off.

A common explanation of the distribution to its stockholders was that it was "impractical" for Datronics itself to run the merger-corporations. Of course, as the minority stockholder, Datronics could not do so. The District Court termed the explanation false and a "pure subterfuge".

Since, however, the District Court was of the opinion that the distribution of the stock among Datronics' shareholders was not a sale, it held that the "misleading statements" were not outlawed by § 10b or by Commission Rule 10b-5. These provisions condemn such misrepresentations only when they are used "in connection with the purchase or sale of any security". Inasmuch as we believe there was a sale in each spin-off, we cannot agree with the District Court's determination. See Securities and Exchange

Comm'n v. Texas Gulf Sulphur Co., 401 F2d 833, 860 (2 Cir. 1968 en banc), cert. denied, 394 US 976 (1969).

This was one of the trial court's reasons for not granting an injunction. Other grounds were that there was no indication that in the future the defendants might violate the statutes in suit; that the officers and agents who formulated and executed the spin-offs were no longer connected with Datronics; and that the present officers and agents assured the District Court that no more spin-offs of this kind would be indulged in. Moreover, the Court felt that by its interpretative releases the Commission had led Datronics and its codefendants to believe that spin-offs were not proscribed by these statutes. The Court was also persuaded by the failure of the Commission to act more vigilantly. While the issuance of an injunction is discretionary, it seems to us that overall, notwithstanding these considerations, the facts in this case warranted the grant of an injunction. See United States v. Parke-Davis & Co., 362 US 29, 47 (1960).

Finally, a summary of the activities of Datronics is conclusively convincing that they violated the statutes in question, and should now be restrained to prevent recurrences. To begin with, it is noteworthy that they were not isolated or minimal transgressions. There were, to repeat, nine sales and distributions of unregistered stocks in little more than a year. They were huge in volume, ranging from 75,000 to 900,000 shares. The distribution was not confined to a small number of recipients; nor was it incidental to Datronics' corporate functions. Concededly, none of the several distributions had a business purpose. In short, the spin-offs seemingly constituted the major operation of Datronics at the time.

We cannot read the releases or letters of the Commission or its abstentions from earlier suits as evincing express or implied approval of the repeated and large-scale

violations as are here. The releases do not approve or condone a campaign, such as Datronics engaged in, to develop means and opportunities to promote spin-offs. Indeed, one of Datronics' agents was a "finder" of opportunities for spin-offs.

The dismissal order of the District Court will be vacated, and the cause remanded for the entry of a judgment sustaining the appellant's motion for the preliminary injunction sought in its complaint.

Vacated with directions.

WIDENER, Circuit Judge, concurring:

I concur in the issuance of the temporary injunction because I believe the existence of the agreements between Datronics and the various companies whose stock found its way to the market through Datronics, on account of the agreements, with no apparent business purpose which has been expressed to us, other than the creation of a public market for the stock, points to the fact that Datronics may have been a willing catspaw in a device or scheme to avoid the statute. For this reason, I believe there is a probable right and a probable danger, and that the right may be defeated unless the injunction is issued. The considerable weight which should be given to the need of protection to the plaintiff is satisfied by the need of protection by the public from possible injury resulting from the violation of the statute. *Sinclair Refining Company* v. *Midland Oil Company*, 55 F(2d) 42 (4th Cir. 1932).

With so much of the opinion as holds that Datronics may be an underwriter within the meaning of the statute, 15 USC 77b(11), I agree. The word "distribution" as used in the statute has not been defined to require value. XXIX Md. Law Rev., 320, 332.

I note that the opinion of the court may not be broadly enough read to cast doubt upon the legitimate business

acquisition of one company by another, or the legitimate business merger of two companies, although a market for securities spun off as a consequence of the transfer may be thereby created; for, as the opinion of the court recites, the market created by Datronics' spin-offs was spurious, doubtless meaning illegitimate, however actual it might have been, and Datronics caused the consummation of the transactions complained of without any business purpose of its own.

In my opinion, the root of this case is the pre-existing agreement between Datronics and the various companies whose stocks it spun off with no apparent purpose other than the incidental benefits of creation of a public market for the stock. If the transactions were with a view to creating a public market for the stock which the various companies could not otherwise do absent compliance with the statute, then I think Datronics may be held to be an underwriter. The value requirement of a sale, 15 USC 77b (3), for the issuer (15 USC §§ 77b(4)) did receive value, I think, may be satisfied by the exchange of stock of the various companies with Datronics or by the exchange of stock of the various companies for services of Datronics. See also 58 Va. L. Rev. 1451.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 72-2240

Opinion on Motions To Reconsider

Decided September 28, 1973

PER CURIAM:

On review of the petition of Datronics Engineers, Inc., appellee herein, for reconsideration of the opinion filed on July 27, 1973 in this case, the Court denies a rehearing

except as to that part of the opinion which remands the cause to the District Court for the entry of the preliminary injunction sought in the complaint of the Securities and Exchange Commission.

In regard to the injunction the Court notes the stressed reassurance, in the petition and the accompanying affidavit, of the owners of a majority of Datronics Engineers, Inc.'s stock that no more spin-offs would be undertaken, that the majority stockholders will not vote their stock in the future for any spin-off transactions or to elect as a director any person who would so vote, that the principals involved in the challenged spin-offs are no longer associated with Datronics, and that a merger of Datronics with another firm is in contemplation. In these circumstances the Court apprehends that its direction to the District Court to issue an injunction might have a punitive effect, which was not intended, and disturb the proposed merger.

Therefore, the Court rescinds so much of its initial opinion as requires the trial court to award a preliminary injunction, and in lieu thereof the cause is remanded for a determination by the District Court, consistently with the remainder of the opinion, of whether an injunction should or should not be issued restraining Datronics in respect to such transactions as the opinion of the Court declares to be impermissible. Nothing herein shall be construed as prohibiting or directing the issuance of an injunction, and the District Court is authorized to consider, if it sees fit, the bona fides of the merger asserted to be in prospect.

In view of the foregoing decision upon the petition of Datronics Engineers, the Court is satisfied that nothing would be gained by extending the time for the appellees, Sylman I. Euzent and John T. Gauthier to file requests for a rehearing, and their requests are denied.

No judge in regular active service or a member of the panel that rendered the instant decision on appeal having

requested a vote on the appellees' suggestion for a rehearing in banc, such a rehearing is denied. Although ordinarily a rehearing will not be granted in the absence of a request by the court for an answer to the petition for rehearing, instantly we deemed an answer unnecessary. See FRAP 40(a).

APPENDIX OF STATUTES AND REGULATIONS

Statutory Appendix

Securities Act of 1933 Act of May 27, 1933; 48 Stat. 74; 15 U.S. Code, Secs. 77a-77aa, as amended.

DEFINITIONS

SEC. 2. When used in this title, unless the context otherwise requires—

(3) The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell," "offer for sale" or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer). Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value. The issue or transfer

of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security.

(11) The term "underwriter" means any person who has *purchased from an issuer with a view to,* or offers or sells for an issuer in connection with, *the distribution of any security,* or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

SEC. 5 (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce of the mails to sell such security through the use or medium of any prospectus or otherwise, or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

SEC. 17 (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to

state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States, District Court for the District of Columbia to enjoin such United States court of any Territory, or the United States acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. * * *

Securities Exchange Act of 1934 Act of June 6, 1934, 48 Stat. 881, 15 U.S. Code, Secs. 78a-78jj, as amended.

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * * * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECTION 21.

* * * * * * * * * * *

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temprorary injunction or restraining order shall be granted without bond. * * *

Rule Under the *Securities Exchange Act of 1934.*

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud.

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale* of any security.

Release No. 33-929, July 29, 1936, 11 F. R. 10957.

17 CFR 231.929. Letter of General Counsel discussing the question of whether a sale of a security is involved in the payment of a dividend.

As I understand the situation, the company proposes to declare a dividend upon its common stock in the amount of one dollar in cash or one-tenth of a share of common stock for each share of common stock held. Each stockholder will be entitled to elect whether to accept the dividend in cash or in stock. Your letter is silent as to the mechanics of the declaration and distribution, and as to the nature of the rights of stockholders who fail to take affirmative action to express their election. In the absence of information regarding these important details, I can answer your question only in a general manner.

Whether or not registration is required in such a case is of course primarily dependent upon whether the offering is of such a character as to constitute it a "sale", as that term is defined in section 2 (3) of the Securities Act. As you are aware, this definition is extremely broad in its scope, and includes every "attempt or offer to dispose of * * * a security * * * for value". The term "value" is not defined in the Act, but should in my opinion be regarded as including not only such ordinary forms of consideration as the transfer of cash or property, but also the waiver or surrender of a right or claim.

However, even though under ordinary circumstances the waiver of a right would in my opinion constitute "value", I do not believe that the term should be regarded as comprehending within its meaning the action of a stockholder, to whom alternative rights have been granted without consideration, in electing to exercise one such right, even though, under the terms of the grant, such election will have the effect of causing the lapse of the right not exercise. Consequently, if a corporation, by simultaneous action of its board of directors, declares a dividend payable at the election of the stockholder in cash or in securities, neither the declaration of the dividend, nor the distribution of securities to stockholders who elect to take the divi-

dend in that form, would in my opinion constitute a sale within the meaning of the Securities Act, and no registration of the securities so distributed would be required under that Act.

However, according to my understanding it is well settled in general law that upon the public declaration of a cash dividend out of surplus, the holders of the stock in respect of which the dividend is declared acquire immediately the rights of creditors of the corporation, and cannot be divested of these rights by subsequent action of the board of directors. If, therefore, there is declared a cash dividend payable to all stockholders, and if the board thereafter determines to grant to stockholders the opportunity to waive their pre-existing and vested right to payment of the dividend in cash, and to receive the dividend in the form of securities, the stockholders electing to take securities would in my opinion be regarded as giving value for the securities so received. Under these circumstances I believe that the securities might well be held to be the subject of a sale.

[Release No. 33-929, July 29, 1936. 11 F. R. 10957.]
FOR RELEASE Wednesday, July 2, 1969

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

Securities Act of 1933
Release No. 4982
Securities Exchange Act of 1934
Release No. 8638

APPLICATION OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 TO SPIN OFFS OF SECURITIES AND TRADING IN THE SECURITIES OF INACTIVE OR SHELL CORPORATIONS.

The Securities and Exchange Commission today made publicly known its concern with the methods being employed by a growing number of companies and persons to effect distributions to the public of unregistered securities in possible violation of the registration requirements of the Securities Act of 1933 and of the anti-fraud and anti-manipulative provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The methods employed can take and in fact have taken a variety of patterns.

I

Frequently, the pattern involves the issuance by a company, with little, if any, business activity, of its shares to a publicly-owned company in exchange for what may or may not be nominal consideration. The publicly-owned company subsequently spins off the shares to its shareholders with the result that active trading in the shares begins with no information on the issuer being available to the investing public. Despite this lack of information, moreover, the shares frequently trade in an active market at increasingly higher prices. Under such a pattern, when the shares are issued to the publicly-owned or acquiring company, a sale takes place within the meaning of the Securities Act and if the shares are then distributed to the shareholders

of the acquiring company, that company may be an underwriter within the meaning of Section 2(11) of the Act as a person "who purchased from an issuer with a view to . . . the distribution of any security" or as a person who "has a direct or indirect participation in any such undertaking."

While the distribution of the shares to the acquiring company's shareholders may not, in itself, constitute a distribution for the purposes of the Act, the entire process, including the redistribution in the trading market which can be anticipated and which may indeed be a principal purpose of the spin off, can have that consequence. It is accordingly the Commission's position that the shares which are distributed in certain spin offs involve the participation of a statutory underwriter and are thus, in those transactions, subject to the registration requirements of the Act and subsequent transactions in the shares by dealers, unless otherwise exempt, would be subject to the provisions of Section 5 requiring the delivery of a prospectus during the forty or ninety day period set forth in Section 4(3).

The theory has been advanced that since a sale is not involved in the distribution of these shares in a spin off that registration is not required and that even if it is required, no purpose would be served by filing a registration statement and requiring the delivery of a prospectus since the persons receiving the shares are not called upon to make an investment judgment.

This reasoning fails, however, to take into account that there is a sale by the issuer and the distribution thereafter does not cease at the point of receipt by the initial distributees of the shares but continues into the trading market involving sales to the investing public at large. Moreover, it ignores what appears to be primarily the purpose of the spin off in numerous circumstances which is to create quickly, and without the disclosure required by reg-

istration, a trading market in the shares of the issuer. Devices of this kind, contravene the purpose, as well as the specific provisions, of the Act which, in the words of the statutory preamble, are "to provide full and fair disclosure of the character of the securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof." In the circumstances of a spin off, when the shares are thereafter traded in the absence of information about the issuer, the potential for fraud and deceit is manifest.

This release does not attempt to deal with any problems attributable to more conventional spin offs, which do not involve a process of purchase of securities by a publicly-owned company followed by their spin off and redistribution in the trading markets.

II

Another pattern has come to the Commission's attention in which certain promoters have acquired corporations which have ceased active operations, or which have little or no assets ("shell corporations"), and which have a substantial number of shares outstanding, generally in the hands of the public. Thereafter the promoters have engaged in activities to quickly increase the market value of their shareholdings. For example, in some cases promoters have initiated a program of acquisitions, transferring assets of dubious value to the "shell corporations" in exchange for substantial amounts of newly issued shares. This activity is frequently accompanied by publicity containing exaggerated or misleading statements and designed to stimulate interest of public investors in the company's shares in violation of the anti-fraud provisions of the Securities Exchange Act of 1934. Thereafter the market prices of these securities have risen sharply under circumstances which bear no relationship to the underlying financial condition and business activities of the company. In

some of these cases the promoters or other corporate insiders, take advantage of the market activity and the price rise which they have generated, have sold their shares at the inflated prices to the public in violation of the registration and anti-fraud provisions of the Federal securities laws. Similar activities have also been noted in a number of cases involving shares which a publicly held company has spun off to its shareholders.

III

The activities discussed above generally can only be successfully accomplished through the efforts of brokers and dealers. Accordingly, brokers and dealers are cautioned to be particularly mindful of their obligations under the registration and anti-fraud provisions of the Federal securities laws with respect to effecting transactions in such securities. In this connection, where a broker or dealer receives an order to sell securities of a little-known, inactive issuer, or one with respect to which there is no current information available except possibly unfounded rumors, care must be taken to obtain sufficient information about the issuer and the person desirous of effecting the trade in order to be reasonably assured that the proposed transaction complies with the applicable requirements. Moreover, before a broker or dealer induces or solicits a transaction he should make diligent inquiry concerning the issuer, in order to form a reasonable basis for his recommendation, and fully inform his customers of the information so obtained, or in the absence of any information, of that fact.

In the foregoing connection the Commission also calls attention to its release dated February 2, 1962 on the subject "Distribution by Broker-dealers of Unregistered Securities" (Securities Act Release No. 4445, Securities Exchange Act Release No. 6721).